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Terrorism and Multinational Corporations: International Business Deals with the Costs of Geopolitical Conflict

John J. Mazzarella

ABSTRACT. Long before U.S. Armed Forces were committed to the Global War on Terrorism, multinational corporations were habitually the targets of extremist organizations. The threat of global terrorism has a negative effect on international business and commerce. This paper explores the most significant costs of terrorism on international business and evaluates methods for minimizing the negative economic impact of global terrorism.

I. Introduction

January 19, 2005: Iraqi insurgents attacked and killed a British security contractor and a Japanese engineer approximately 155 miles north of Baghdad; both men were employed by civilian corporations involved in Iraq's post-war rebuilding efforts [MSNBC, 2005, par. 1]. March 31, 2004: Four private contractors were ambushed in their sport utility vehicle as they passed by the city of Fallujah, Iraq. Insurgents set the contractors' vehicle ablaze, beat two of the charred bodies with a pole, dragged another body through the streets, and hanged two of the corpses on an iron bridge overlooking the Euphrates River [CBS/AP, 2004, par. 1-5]. September 11, 2001: Three thousand people went to their jobs in the World Trade Center one morning and never returned home. Two hijacked passenger jetliners were flown into the Twin Towers in the worst terrorist attack on the homeland in U.S. history [Cloud and King, 2001, p. A-1]. The principal victims of these horrific acts of murder were not military personnel trained for combat, but civilian employees of multinational firms operating in the modern global economy. One cannot read newspaper headlines or view news broadcasts in the years since September 11th without being exposed to some development in the Global War on Terrorism. There is little doubt that today's world is a very dangerous place in which to conduct business and commerce.

Global terrorism exacts high costs in terms of lives lost and property destroyed–the obvious costs of terrorism. There are, however, other costs less widely recognized but just as real. The threat of global terrorism has a significant, negative effect on international business and global commerce. Multinational corporations, as the main purveyors of international business, have for decades included the business costs of terrorism in their international plans and operations. The threat of terrorism raises costs so much that in 1980, a survey of eighty-two high-level international executives ranked terrorism second only to then double-digit inflation as "a barrier" to their international businesses [Ryans and Shanklin, 1980, p. 68]. Some of the business costs due to terrorism are quantifiable, while many are not. In any case, terrorism is a significant drag on the global economy that the truly internationally focused manager cannot simply ignore.

II. Identifying the Costs of Terrorism on International Business

A. IMPROVING THE PHYSICAL SECURITY OF PERSONNEL, PLANT, AND EQUIPMENT

From a managerial economics perspective, multinational corporations incur a wide range of significant business costs, both fixed and variable, due to the threat of global terrorism. One fixed cost involves upgrading the physical security of the firm's personnel, property, plant, and equipment located in areas where "…the incidence/likelihood of terrorism against a multinational firm–its employees and property–is well above average risk" [Ryans and Shanklin, 1980, p. 67]. It can be very costly for an international firm to develop an effective physical security plan. The process normally involves a detailed initial security survey of office spaces, buildings, and other property owned by the firm. From the initial security survey, the corporate management may decide to make "hardware" improvements to physical security, including installing closed-circuit surveillance cameras, establishing metal detectors at building entrances, and possibly installing reinforced doors in executives' offices [McKennan, 1994, par. 2, 4-7]. A survey of 178 multinational corporations conducted in 1993 showed that, in terms of response to the threat of global terrorism, they spent the most company funds on "equipment-based" security–installation of security devices and other physical protection of corporate assets [Harvey, 1993, par. 9 and 19].

International firms may also decide, as part of improving their physical security, to hire additional security personnel to guard their property and employees overseas. This decision not only involves direct costs in terms of fees for additional outside security services, but it also may create some unintended costs for the corporation. The hiring of additional security personnel may signal to corporate employees that the firm is under threat of imminent attack, causing negative psychological effects in some employees that will, in turn, possibly reduce their job performance. International executives may also be forced by circumstances to yield some of their decision-making power to hired security personnel–perhaps a necessity for security reasons, but not necessarily efficient for conducting business operations [Ryans and Shanklin, 1980, p. 70].

B. SECURITY CONSULTANTS

Many multinational executives employ outside security consultants for advice on confronting the threat of terrorism. Security consultants provide detailed economic and political analysis of high-risk areas of interest to international firms. Outside security consultants deepen the global managers' understanding of emerging and existent terrorist threats to business operations. Security consultant services enable international managers to conduct more accurate terrorism risk modeling and, in turn, make more informed business decisions. The fees charged by security consultants are fixed, short-term costs for client firms; however, the short-term costs seem a small price to pay for the long-term cost savings of avoiding a terrorist attack.

Multinational corporations increasingly view the sometimes expensive, short-term cost of security consultant services as a necessity for conducting international business. By January 2003, seven major international corporations had joined "The Corporate Preparedness, Security, and Response Network." Each of the seven members of the network were willing to pay an annual fee of $10,000 to be provided "…with information on best corporate security practices as well as a chance to exchange security ideas…" [Fannin, 2003, par. 12-17]. World Markets Research Center, a commonly used security consultant firm, provides its "Global Terrorism Index" as a basic service to client firms for $1500. The "Global Terrorism Index" summarizes the results of risk modeling for 186 countries. The index assigns a ratings scale for global managers to compare risk levels across regions. The index not only quantifies and compares the business risks of terrorism, it also "helps companies… make informed decisions and seize business opportunities" [World Markets Research Center, 2005, par. 1-2]. World Markets Research Center and other consultant firms provide additional analysis services for increased fees.

C. GLOBAL SUPPLY CHAINS

Global supply chains are especially vulnerable to terrorist attack. The costs of securing the global supply chain vary with the amount of global commerce utilized by a particular multinational firm. The supply chain costs caused by terrorism stem not only from securing the transportation of goods, but also from the risk of delay or disruption of global supply sources due to terrorist activity.

The shipping industry directly experiences, and passes along to its customers, the higher cost pressures due to the risk of terrorism. Few sectors of the global economy are untouched by international shipping; the United Nations estimated in 2001 that ocean-going vessels "carry 80 percent of the world's traded cargo…" [*The Economist*, 2003a, par. 8]. Ocean commerce lanes have become increasingly susceptible to piracy, especially in the Southeast Asia region. The region experienced a thirty-seven percent increase in incidents of shipboard piracy during the first half of 2003, with the pirates displaying a tendency to board the ship, steal the cargo, ransom the crew as hostages, then refit the captured ship and use it for their own illegal operations. The Southeast Asia piracy incidents may not have been motivated simply by criminal intent. Aegis Defense Services, a security consultant firm, postulated that some of the piracy incidents were actually "training missions" for future terrorist attacks on the high seas [*The Economist*, 2003a, par. 2-3].

In the post-September 11th era, the U.S. Federal Government imposed more restrictive shipping regulations and standard practices with the intent of increasing security, but the government's policies have created unintended costs and complexities for international business. Since September 16, 2001, the U.S. Coast Guard has regularly escorted gas tankers heading into the port of Boston from 200 miles away from the harbor in order to prevent terrorists from taking control of a tanker and using it as a weapon of mass destruction [*The Economist*, 2003a, par. 6]. New initiatives from the U.S. Customs Department, such as the Customs-

Trade Partnership Against Terrorism, the Container Security Initiative, and the "Twenty-Four Hour Rule" for advance filing of manifests, have made it more difficult for terrorists to wreak havoc on America's ports but have also increased compliance costs for participating corporations [Weise, 2005, par. 1]. There are over 46,000 merchant ships operating on the open seas and over 4,000 ports worldwide [*The Economist*, 2003a, par. 9]. As the United States and other countries institute stricter commerce security policies, it is no small or inexpensive task for international businesses to ensure the security of their sea-borne transportation chains.

The financial costs of security for shipping are staggering. A report in the summer of 2003 estimated that the shipping industry invested $1.3 billion on "improved security," and the industry would, from 2003 onward, incur costs of $730 million per year in order to "maintain better security systems" [*The Economist*, 2003a, par. 9]. The risk for failing to secure the transportation of goods, however, greatly outweighs the compliance costs by most estimates. International criminals have often used shipping containers to smuggle drugs across international boundaries. There exists a very real possibility that terrorists could plant a weapon of mass destruction within a shipping container. A terrorist incident of this magnitude "could have long-term devastating effects on global trade" [Weise, 2005, par. 3]. Deloitte-Touche Tohmatsu, a global consulting firm, estimated that multinational corporations could potentially lose up to "a collective $1 trillion" from "a security breach of just one shipping container" [*Journal of Commerce*, 2004, par. 1].

In addition to helping avoid the public relations catastrophe of a security breach, the expenditures made by international firms to protect their global supply chains may have an additional positive benefit. In some cases, the security expenditures may actually "drive efficiency into the supply chain." International firms tighten internal supply controls and impose high performance standards on their transportation systems in order to comply with stricter security regulations. A U.S. Government and private joint protection initiative in 2004 was estimated to have actually "generated cost savings of between $378 and $462 per shipping container" [*Journal of Commerce On-Line,* 2004, par. 10]. For the most part, however, the increased security costs passed along from the shipping companies to the multinational corporations are a drawback to international operations. International firms rely too heavily on merchant shipping for their operations to be immune from the increased expenses and complexities of post-September 11th global commerce.

In addition to increasing shipping security costs, terrorism also increases the risk of disruptions along the global supply chain. International shipping may be disrupted for various lengths of time in response to a major terrorist attack, as in the case of the immediate aftermath of the September 11, 2001 attacks. During the days and weeks following September 11th, many trucks were delayed at the Canadian border for security reasons prior to entering the U.S. The transportation delay caused an immediate, massive shortage of globally sourced parts for the American auto industry [Chopra and Sodhi, 2004, p.55]. Many international firms rely upon just-in-time inventory methods to hold down inventory costs, but the cost advantage of lower on-hand inventory levels is counterbalanced by just-in-time's high vulnerability to terrorist disruption. Some managers choose a more costly method of simply holding excess inventory to hedge against the risk of terrorist disruptions [Chopra and Sodhi, 2004, p. 54].

Other firms choose a more selective approach to increasing inventory levels. These firms increase their on-hand inventories of items "with low holding costs and no danger of obsolescence," such as petroleum. They also have redundancy in supply sources for items "with high holding costs or a high rate of obsolescence." Motorola, Inc. purchases handset components (a high-volume input with a high rate of obsolescence) from several vendors to hedge against supply disruption. The selective approach attempts to protect against terrorist attack without "building up fast-depreciating inventory" [Chopra and Sodhi, 2004, p. 56].

In any case, the global supply chains of multinational firms are beset with serious security and inventory pressures due to the threat of terrorism. International managers must strike a strategic balance between the competing goals of maximizing supply chain security and minimizing inventory costs. To successfully overcome the costs of terrorism and advance their businesses, global firms must implement effective transportation security measures while maintaining appropriate inventory levels.

D. REDUCED DIRECT INVESTMENT AND OPERATIONS IN HIGH RISK AREAS

Some international firms may reduce their direct capital investments or business operations within geographic areas of high terrorism risk. A survey of international executives predicted that increased terrorist attacks over time would "ultimately lead to more and more multinational companies retreating from positions of heavy involvement" [Ryans and Shanklin, 1980, p. 67]. For international firms considering expansion through direct investment in hostile regions, the "retreat" method may hold true. A French respondent to the survey of international executives claimed that his company "avoids high-risk countries when building new plants" [Ryans and Shanklin, 1980, p. 67]. Although some firms choose to reduce overseas operations or direct investment, the choice leads to opportunity costs. A reduction in direct investment or foreign operations causes firms to miss potentially lucrative foreign business ventures and lose access to potentially less costly foreign factors of production.

Many multinational corporations choose not to retreat from terrorism risk. KBR, a subsidiary of Halliburton, continued operations in Iraq after forty-two of its employees were killed in various terrorist attacks during 2003-2004 [*The Economist,* 2004, p. 9]. Israel, a nation particularly vulnerable to terrorism, experienced foreign direct investment inflows of $3.745 billion in 2003, amounting to 20.1 percent of its gross fixed capital formation [UNCTAD, 2005a, p. 1]. World Markets Research Center ranked Colombia in 2003-2004 as having the highest risk of terrorism [World Markets Research Center, as quoted in *The Economist,* 2003b, par. 1]. However, several multinational corporations thrive in Colombia's high-risk environment. In 2002, BP Exploration Company Ltd. achieved $404 million in sales from petroleum operations in Colombia and employed 600 Colombians. Outside of the petroleum industry, Tellabs International, Inc. achieved over $1 billion in sales from Colombian operations [UNCTAD, 2005b, p. 28]. Managers of multinational corporations may be willing and able to accept higher terrorism risk levels if overseas operations and investments are forecasted to yield substantial rewards.

E. PERSONNEL ISSUES

The threat of terrorism causes some multinational firms to make, at times, inefficient personnel decisions. The personnel decisions intended to mitigate the risk of terrorism often impose some unintended, long-term costs on the firm. Terrorism causes global managers to consider carefully the use of expatriates in foreign assignments [Ryans and Shanklin, 1980,

p. 68]. Expatriates are defined as "employees who live and work in foreign countries on short-term or long-term assignments." The use of expatriates helps make the executive corps of a multinational firm more "culturally aware" and assists in expanding the firm's international operations by building "interpersonal networks of global contacts" [Schermerhorn, 2005, p. 131]. Generally, expatriates returning from successful foreign assignments advance within their particular corporations to upper management levels, bringing real international experience to the senior leadership positions of their firms. A lack of expatriates filling overseas assignments may create over time "an isolationist orientation" among the highest management levels of a particular multinational corporation [Ryans and Shanklin, 1980, p. 68]. An upper-management "isolationist orientation" will almost certainly create a drag on a company's international operations and global strategic decision-making processes. Thus, it would seem that assigning expatriates overseas is a practical necessity for multinational corporations in order to maintain their competitive edge in the global market.

The competitive edge associated with assigning expatriates must be balanced, however, against the particular level of political risk involved [*The Economist*, 2004, p. 9]. Sending expatriates into an already politically hostile foreign environment may actually encourage acts of terrorist violence against the multinational corporation's executives, assets, or business interests. KBR lost forty-two employees by August 2004 due to terrorist violence in Iraq and Kuwait [*The Economist*, 2004, p. 9]. By contrast, Aeon Corporation consciously did not assign expatriates to its Kuwait and Turkey offices at the outset of Operation Iraqi Freedom and thereby reduced its exposure to the elevated terrorist risk level associated with the conflict [*Business Insurance*, 2003, par. 7]. A multinational firm must decide the maximum level of risk it is willing to accept before withdrawing expatriates from a particular geographic area of operations.

The controversy of weighing the terrorist threat level versus the advantages of using expatriates also may create adverse selection problems. International firms may decide to only assign unmarried expatriates so as to avoid the additional risks involved with sending entire families overseas. The unmarried executives chosen may reduce the risk exposure of the firm, but they may not actually be the best qualified or most capable for the particular job [Ryans and Shanklin, 1980, p. 68]. Adverse selection costs to the business also become an issue on both ends of the "risk-taker" spectrum. Some less-than-capable executives who are natural "risk-takers" may volunteer for overseas duty in dangerous places for the sheer "thrill" of the experience, not to advance the interests of the company. Natural "risk-avoiders" may be involuntarily assigned to dangerous areas and fail to react boldly to credible terrorist threats [Ryans and Shanklin, 1980, p. 69].

There are other personnel costs created by the threat of terrorism. If multinational corporations decide to assign expatriates, the companies must develop and rehearse evacuation policies and procedures in the case of elevated terrorist threat advisories. The firms must decide in advance of the actual contingency many issues such as determining the alternate location the expatriates will evacuate to, who among the overseas staff and their families is eligible to evacuate in an emergency, and what kind of "skeleton staff" should remain in place to avoid a total breakdown of business operations [*Business Insurance*, 2003, par. 26-27, 29].

Multinational corporations usually experience difficulties in recruiting and retaining qualified personnel in certain geographic areas. Low morale (and resulting low job performance) may creep into the pools of overseas personnel who work in extremely risky locations and are forced to live under restrictive security measures limiting their "freedom of movement" [Solomon, 1997, par. 15]. When a global manager determines that the risk to expatriates is beyond acceptable limits, there will be costs to the firm to permanently relocate expatriates and their families [Lincoln, 2002, p. 6].

To ensure personnel safety, human resource managers constantly monitor situational trends outside the regular boundaries of the business. Human resource managers may be required to analyze trends such as government travel advisories affecting business travelers and recent local security and political developments [Solomon, 1997, par. 28]. The decision to suspend travel due to government advisories helps secure the safety of a firm's traveling personnel, but the decision usually involves an implicit cost of lost international business opportunities [Lincoln, 2002, p. 6].

Multinational firms may expend resources developing specialized safety training plans for overseas executives. The training programs may include teaching techniques to avoid falling victim to terrorist activities [Harvey, 1993, par. 12]. According to a Council on Competitiveness survey, sixty-three percent of multinational corporations observed a need to add a "chief of security" to their top-level management. The respondents were willing to accept the costs of additional salary and benefits for a vice-presidential level executive specializing in physical security [Fannin, 2003, par. 20-21].

Another personnel cost related to the risk of terrorism is the higher compensation international firms pay to employees who are "third country nationals." Third country nationals are usually "high-profile" specialists who play a vital role in correcting operational problems for multinational firms in locations around the globe [Hansen, 2002, par. 3]. The third country nationals' higher mobility makes them especially vulnerable to terrorist attack. A survey of multinational corporations in 2002 indicated that third country nationals usually receive some additional benefits to compensate them for their increased exposure to terrorism. The increased compensation packages commonly included "international medical plans," a "two times salary" death benefit, and a "sixty percent of salary" long-term disability benefit [Hansen, 2002, par. 6]. Under most circumstances, multinational corporations must pay higher compensation expenses to third country nationals to account for their higher susceptibility to terrorism.

F. POLITICAL RISK INSURANCE

Due to the uncertainty of terrorism and other geopolitical disruption factors, international businesses bear the costs of political risk insurance. Political risk is defined as "the potential loss of one's investment in or managerial control over a foreign asset because of instability and political changes in the host country" [Schemerhorn, 2005, p. 130]. Political risk includes the threat of terrorism. Multinational corporations with long-term projects in unstable developing regions, such as oil companies, are especially susceptible to political risk.

Generally, underwriters claim that terrorism is an "uncertainty" rather than an actual quantifiable risk; therefore, insurers claim they cannot accurately price the risk premium of terrorism [Levinsohn, 2002, par. 5]. September 11th solidified the property-casualty insurance industry's opinion that terrorism risk is unquantifiable. William Berkley, chief executive officer of a prominent insurance company, predicted in the aftermath of the 2001 attacks, "This [the September 11th attacks] is going to change how people think about high-limit property coverages" [William Berkley, quoted in Oster *et al.,* 2001, p. B1]. Several key insurance industry leaders wrote to the Bush Administration in October

2001, "[Insurance] policies for acts of terrorism are impossible to price and therefore impossible to write" [Unnamed Insurance Industry Leaders, as quoted in Levinsohn, 2002, par. 5]. Underwriters also face significant financial exposure to terrorist attack, as seen in the estimated $50 billion to $70 billion in claims filed as a result of September 11th [Levinsohn, 2002, par.1]. Thus, in the immediate period after September 11th, insurers either completely ceased offering terrorism insurance or charged higher overall insurance premiums to account for terrorism pricing problems and to reduce their potentially overwhelming exposure [*The Economist*, 2000, par. 26].

To alleviate the market problems of political risk insurance, to limit underwriters' costly exposure to terrorism, and to increase the amount of risk insurance available to businesses post-September 11th, the U.S. Congress passed the Terrorism Risk Insurance Act (TRIA) in November 2002. Under the TRIA legislation, the U.S. Government (for a limited three-year period) set maximum levels of insurer liability for terrorist attacks and agreed to reimburse insurance companies for large portions of losses due to attacks meeting certain Department of Treasury criteria [Government Accounting Office, 2004, p. 2]. The Congress intended to make terrorism insurance affordable and widely available. The Congress also intended to temporarily relieve the tremendous terrorism risk exposure of the insurance industry so the industry could develop fair terrorism insurance pricing methods [Government Accounting Office, 2004, p.1-2].

In 2004, the Government Accounting Office (GAO) reported that the U.S. Federal Government's pledged support to the insurance industry had indeed led to increased availability of terrorism risk insurance. The GAO report also indicated, however, that the insurance industry had still not developed viable terrorism risk insurance pricing methods [Government Accounting Office, 2004, pp. 4-5]. Even with the American taxpayers serving as a temporary support mechanism for the insurance industry, multinational corporations still currently face the cost of higher overall insurance premiums in the absence of an accurate, industry-wide terrorism risk insurance pricing system.

III. Managing the Risk of Terrorism

A. TERRORISM RISK MANAGEMENT METHODS

Political risk insurance is one of several methods global business leaders use to manage terrorism risk and minimize the costs of terrorism.

Multinational corporations also hire additional security personnel or security consultants, "harden" their physical assets and work sites, and train personnel to avoid becoming victims of terrorism.

International firms may also choose among other alternatives. First, firms may be able to discourage terrorist attack by maintaining an impeccable "environmental and human rights" record within their areas of operations [*The Economist*, 2000, par. 25]. Political risk can be managed if firms expend resources bolstering a positive reputation in their foreign locations rather than displaying only an exploitive public image. Second, firms may use subcontractors to further manage risk. The subcontracting method is especially useful for extractive industries such as mining or oil. The large extractive firms may subcontract the prospecting phase of operations to smaller companies. The prospecting phase carries the greatest exposure to political risk due to the length of time and number of personnel required in dangerous locations. The smaller subcontractors inherit the majority of the political risk encountered during the prospecting phase. The larger extractive company then assumes the risk during the shorter (and somewhat less risky) extractive phase of operations [*The Economist*, 2000, par. 27].

B. RISK MODELING

The methods for managing the risk of terrorism (and thus minimizing terrorism's costs) rely greatly upon effective risk modeling. Computer risk modeling has become "standard practice" for managers to estimate future losses [O'Brien, 2004, par. 3]. Managers normally begin with a full physical security analysis of their firm's business sites (conducted internally by the firm or contracted through outside security consultants). The security analysis results become inputs for computer risk modeling programs. The computer models determine the probability of terrorist attack and expected level of damage by way of statistics, engineering, and other technical procedures [O'Brien, 2004, par. 14]. Proper risk modeling enables corporate managers to determine the actual amount of terrorism risk insurance coverage required for their particular business. Managers then can share the risk modeling results with insurance underwriters to negotiate lower premiums or reduce coverage levels. A prominent finance company in New York City performed terrorist risk analysis of its site, showed the results to its insurance underwriter, and saved over $400,000 in premium costs [O'Brien, 2004, par. 36-39]. Increasingly, international businesses require global managers who not only understand business theory and practice but who also understand risk modeling.

Managerial economics provides a theoretical background for risk modeling. In nearly all decision-making processes, managers must remain aware of the effects of their decisions upon the present value of the firm's future profits in a basic valuation model:

$$PV = \Sigma(\pi/(1-i)^t)$$

The value of *i*, the discount rate, depends on the overall risk of the firm and on the condition of capital markets [Mansfield *et al*., 2002, p. 13]. The basic valuation model can be adjusted for risk by adding a risk premium to *i,* changing the standard discount rate to a risk-adjusted discount rate. The risk premium is the difference between the risk-free rate of return and the expected rate of return required to compensate investors for the firm's level of risk [Mansfield *et al.*, 2002, p. 552-553]. International managers should include an estimate of terrorism risk within the risk-adjusted discount rates used in valuation models.

IV. Conclusion

From improving the physical security of corporate assets to managing personnel issues in high-risk environments, multinational corporations experience a wide range of negative effects due to the threat of terrorism. As multinational corporations continue to operate across international boundaries, they will undoubtedly continue to clash with fanatical terrorist groups bent on achieving political goals through violent means. Even with the U.S. and its allies militarily engaged in the Global War on Terrorism, the people, the facilities, and the operations of multinational firms will continue to be favorite targets of terrorist attack. Global terrorism causes international firms to divert scarce resources and management talent away from primary business operations to focus on mitigating the risk of terrorist attack. Global terrorism creates significant business costs for multinational firms that must first be understood by managers and then must be minimized to the greatest extent possible. To do otherwise would not only degrade the overall health of the global economy but also serve to encourage more terrorist violence against multinational corporations in the future.

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